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Daniel Weintraub: Schwarzenegger's idea would help tame deficits

By Daniel Weintraub

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For at least a generation, California's government has been plagued by a feast-or-famine tax system that produces huge revenue windfalls in good times and then flattens in bad times.

These roller coaster rides come largely because of the state's heavy dependence on a progressive personal income tax. The rich pay most of the income taxes, and when the rich get richer, they pay a lot more. When their incomes level off, they pay relatively less, and the state budget suffers the consequences.

The problem is that legislators and governors spend all the money that comes in during the good times, or they use the temporary windfalls as a reason to cut taxes. But when the windfall goes away, those spending and tax decisions remain on the books. The result: big gaps between the tax revenue coming into the state and the projected, ongoing cost of government.

This happened in the early 1990s and again after the dot-com boom around 2001. To a lesser extent it happened one more time in the middle part of this decade, as resurging stocks and a hot real estate market led to big increases in tax revenues. Now that growth has leveled off, and Gov. Arnold Schwarzenegger and lawmakers face a \$14 billion shortfall.

The governor and the Legislature will have to cut spending or raise taxes to get out of that hole. But Schwarzenegger has also proposed a long-term fix that he believes would help end the roller-coaster rides. His idea is worth a close look.

Schwarzenegger's plan has two distinct parts. The first would smooth the state's revenues, socking away money in good times and then using that money to cushion the blow when the economy inevitably slows. The second part would seek to force the Legislature to plan ahead for bad times while giving future governors more power to cut the budget when lawmakers don't. The first part of Schwarzenegger's proposal is much stronger than the second.

The idea of smoothing out the peaks and valleys in the revenue stream has merit. This could be done by broadening the base of taxpayers so government is not as dependent on the fortunes, literally, of the state's wealthiest residents. But since that kind of major surgery is not likely to happen any time soon, the next best alternative is to live with the tax system we have but change the way the politicians spend the money.

Schwarzenegger's proposal is ideologically neutral. It is not a spending limit, and it would not shrink the size of government over time, in real terms or as a share of the economy. It is a revenue limit that would postpone the day when lawmakers can spend some of the money that comes into the treasury but still allow all of the money to be spent eventually.

It would do this by calculating the 10-year average of the growth in the revenue stream supplied by the taxpayers, and sequestering any money that comes in above that average growth line. In years when revenue growth falls below the trend line, the money in the reserve would be released to help fill the gap.

This is a big improvement over the rainy day fund that Schwarzenegger persuaded voters to approve in 2004. That plan, part of Proposition 58, relied on the discretion of the governor and legislators to work. And as we have seen, if the money can be spent, it will be spent. The governor's new proposal would automatically fill the reserve in good times and keep the money off the budget books in a special fund that could be tapped only when revenue growth slowed.

If the plan had been law since 1998, before the dot-com boom, it would have sequestered much of the revenue windfall in the late 1990s, then released it during the brief recession that followed. The plan is not perfect. It helps smooth out the bumps but cannot completely eliminate them.

Today, according to a Department of Finance analysis, the state would still be facing a deficit even if the plan were in effect, but it would be smaller than the one the governor is struggling to close.

The second part of Schwarzenegger's proposal is more problematic. He wants to require the Legislature to plan in advance how to cut the budget each year if revenues fall short of projections, then have that plan implemented automatically if the need arises. If the Legislature failed to complete this task, the governor would be empowered to cut the budget unilaterally.

Those changes would certainly make the response to a looming deficit more efficient and potentially more effective. But if the revenue averaging plan were in place, the automatic budget cuts would be less necessary. In any case, the idea sounds like a power grab by the governor, and it would taint any effort to persuade the voters to approve the first part of Schwarzenegger's plan.

The governor would be better served by focusing on the laudable and less controversial idea of reducing the volatility in California's tax system while leaving the notion of power shifts for another day.